



Catching Up On Cryptocurrency

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What is Bitcoin?

- ◆ Bitcoin could be characterized as:
 - a currency;
 - a commodity;
 - an intangible;
 - a contract;
 - a collectible; and
 - a security.

IRAs

- ◆ Self-directed IRAs not subject to ERISA, and avoid the ERISA fiduciary issues.
 - IRAs are subject to Internal Revenue Code prohibited transaction rules, but not a significant issue with respect to cryptocurrency.
 - Should be covered under blind transaction doctrine.

IRA Custodian Rules

- ◆ Self-directed IRAs must still comply with Code's IRA rules.
 - *McNulty v. Commissioner*, 157 TC No. 10 (November 2021)
- ◆ If assets require safekeeping, trustee must deposit them into an “adequate vault” and keep a permanent record of deposits and withdrawals from the vault.

IRA Custodian Rules

- ◆ Qualified custodian must be responsible for management and disposition of property in a self-directed IRA.
- ◆ A custodian must maintain custody of IRA assets, maintain required records, and process transactions that involve IRA assets.
- ◆ Query-Does self-directed IRA holding crypto currency satisfy these requirements.
- ◆ If custodian not a bank, same rules apply to tax qualified plans under Code Section 401(f).

Overview

- ◆ Reasons employers may be considering adding cryptocurrency to investment platform:
 - Cryptocurrency's strong economic showing in 2021;
 - Cryptocurrency becoming more mainstream; or
 - May provide additional asset diversification.
- ◆ Increased government oversight of cryptocurrency by regulators and Congress.
 - Employee interest in investing in cryptocurrency:
 - Could increase 401(k) plan participation by including it in platform.

Overview

- ◆ Still a high-risk proposition today from perspective of potential fiduciary liability.

Variety of Issues Under ERISA

- ◆ IRS treats cryptocurrency as property, so investing in cryptocurrency is, from that perspective, same as investing in stocks or mutual funds.
- ◆ No per se prohibition against investing in cryptocurrency under ERISA.
- ◆ Investment in cryptocurrency subject to the same legal requirements as any other plan investment.
- ◆ Threshold inquiry is prudence.

Duty of Prudence

- ◆ ERISA Section 404(a) requires plan fiduciaries to act with the care, skill, prudence, and diligence under the circumstances that a prudent person acting in a like manner and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
- ◆ Focus is on process, not on results.
 - However, the investment decision takes into account both substantive and procedural prudence.

Knowledge Concerns at Two Levels

- ◆ Investing in cryptocurrency presents knowledge issue at two levels:
 - Plan sponsor or plan committee adding cryptocurrency to plan's investment platform; and
 - Plan participant investing in cryptocurrency.

Compliance Assistance

Release 2022-01

- ◆ DOL expressed “serious concerns” about a defined contribution plan such as a 401(k) plan offering direct investments in cryptocurrencies or products whose value is tied to cryptocurrency.
 - Does not distinguish between different types of cryptocurrencies.
 - Did not address IRAs.
 - Did not address defined benefit pension plans.

Compliance Assistance

Release 2022-01

- ◆ In crypto currency's early stages, significant risks of fraud, theft, and loss.
- ◆ DOL expects to conduct investigative programs at plans offering cryptocurrency investment options.
 - Plans offering brokerage windows permitting such investments will be questioned about reconciling such actions with fiduciary duties of prudence and loyalty.

Compliance Assistance

Release 2022-01

- ◆ DOL had six significant areas of concern.
 - ◆ Speculative and volatile investments;
 - ◆ Challenges for plan participants to make informed investment decisions;
 - ◆ Custodial and recordkeeping concerns;
 - ◆ Valuation concerns;
 - ◆ Implicit endorsement by relevant plan fiduciary; and
 - ◆ Evolving regulatory environment.

Duty of Prudence Works Both Ways

- ◆ Focus of duty of prudence is on process, not results.
 - ◆ Hindsight evaluations do not establish imprudence.
 - ◆ Generally applied when an investment option performs poorly, and claim is the investment option should have been removed from plan's investment menu.
- ◆ Same argument available if investment option increases substantially in value and the complaint is that the investment option should have been retained as part of investment menu.

Adding Cryptocurrency to, or Retaining Cryptocurrency on, a 401(k) Platform

- ◆ Guidance subject to change as cryptocurrency ceases to be the “wild west.”
 - SEC has approved a crypto currency futures fund.
 - SEC has been asked to approve ETF cryptocurrency funds.
 - NASDAQ may permit bitcoin trading.
- ◆ If these changes occur, DOL position could be modified to some extent.
- ◆ These changes will not address all of DOL’s concerns.

Adding Cryptocurrency to, or Retaining Cryptocurrency on, a 401(k) Platform

- ◆ Discuss with employee benefits counsel prior to implementing.
- ◆ To the extent possible, address DOL concerns in Compliance Assistance Release 2022-01.
- ◆ Ensure that relevant plan fiduciary or investment advisor or investment manager has necessary knowledge and expertise.
- ◆ Provide plan participants with maximum amount of information possible about cryptocurrency.

Adding Cryptocurrency to, or Retaining Cryptocurrency on, a 401(k) Platform

- ◆ Ensure that custodian have the capacity to both safeguard and custody cryptocurrency.
- ◆ If plan is administered pursuant to an investment policy statement, modifications to IPS may be required.
- ◆ Place cap on percentage of plan assets that can be invested in cryptocurrency.
- ◆ Review relevant insurance policies to confirm that cryptocurrency losses will be covered.

Adding Cryptocurrency to a 401(k) Platform

- ◆ Consider addition of self-directed brokerage accounts.
 - Plan fiduciaries may be considering this structure for participant ESG investments.
 - Need to take into account DOL's concern about brokerage windows in Compliance Assistance Release 2022-01.

Selection of a Custodian

- ◆ Selection of service provider to a plan such as a custodian is a fiduciary activity.
- ◆ OCC opinion letter in 2020 held that national banks can perform custodial services for cryptocurrency.
 - Before a national bank can accept custody of cryptocurrency, it must perform a preacceptance review.
 - Some states also addressing the issue.

Selection of a Custodian

- ◆ A bank acting as a custodian may engage a sub-custodian for cryptocurrency.
 - Different methods by which banks can custody cryptocurrency.
- ◆ Custody agreements for cryptocurrencies may contain unique provisions.
 - Treatment of forks or splits in the currency being held.

Valuation Issues

- ◆ Holding cryptocurrency presents two types of valuation issues: administrative and investment related.
- ◆ Federal tax treatment: If virtual currency is listed on an exchange and the exchange rate is determined by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into US dollars (or into another real currency at the exchange rate, and then converted into US dollars), in a reasonable manner that is consistently applied.

Valuation Issues

- ◆ Valuation of cryptocurrency held by plan participant necessary for determining amount of distribution; whether mandatory distribution required; QDRO allocations and maximum loan available.
 - Failure to satisfy required minimum distribution requirements can subject participant to a 50% excise tax.
 - Understating a participant's distribution can result in penalties for under withholding.

Valuation Issues

- ◆ ERISA Section 3(26) requires current value—fair market value when available and otherwise fair value as determined in good faith by a trustee or named fiduciary, pursuant to plan terms, and in accordance with regulations of Secretary, assuming an orderly liquidation.
 - Form 5500 reporting done on a current value basis, with current value restated at end of plan year.

Valuation Issues

- ◆ Accounting FASB 820: a fair value measurement contemplates an orderly transaction to sell the asset in its principal market, or in the absence of a principal market, its most advantageous market.
 - The market in which the plan normally transacts for the crypto asset is presumed to be the principal market.
 - However, relevant plan fiduciary needs to consider if information provided by market is reliable and whether or not the market is inactive.

Valuation Issues

- ◆ Former Federal Reserve Chair and Treasury Secretary Yellen labelled bitcoin a highly speculative asset, and not a stable source of value.
- ◆ Not easily benchmarked against other digital currencies because there are currently no good valuation metrics.
- ◆ SEC has cautioned investment in cryptocurrency is highly speculative.
- ◆ FINRA has warned of complications arising from use of cryptocurrency in illegal activities.

Indicia of Ownership

- ◆ ERISA Section 404(b)-fiduciary cannot maintain indicia of ownership of plan assets outside jurisdiction of United States District Courts.
 - Exceptions applicable to foreign securities or foreign currency incident to purchase, sale, or maintenance of foreign securities.
- ◆ Congressional intent was to prevent “runaway assets.”
 - Objective of indicia of ownership requirements is to preclude frustration of adequate fiduciary supervision and remedies for a breach of trust.

Indicia of Ownership

- ◆ Initial indicia of ownership regulations issued in 1977.
- ◆ Notion that an investment has physical indicia that can be held is a concept that made more sense in 1997 than it does in 2021.
- ◆ Two key questions: What is the indicia of ownership of bitcoin, and where is it located?

Collectibles

- ◆ Some plans prohibit investing in collectibles under Code Section 408(m).
- ◆ The acquisition of a collectible by an IRA or an individually directed account under a tax qualified plan treated as a distribution.
 - Subject to 10% excise tax for early withdrawal.
- ◆ Does not affect plan's tax qualified status.
 - Taxable amount equal to the cost of the collectible.

Collectibles

- ◆ Definition of collectible includes any stamp or coin.
 - Bitcoin should not be treated as a coin for this purpose:
 - Collectible must be tangible personal property; and
 - Bitcoin is an intangible asset.
 - Probably a different result for nonfungible tokens.
 - Possible prohibited transaction.

Form 5500 Audit Requirement

- ◆ Could jeopardize small plan audit waiver.
- ◆ One of conditions to qualify for the small plan waiver is that, as of last day of preceding plan year, at least 95% of a small pension plan's assets must be qualifying plan assets or, if not, person handling qualified plan assets must be bonded in an amount equal to the value of nonqualifying assets.
 - Bitcoin would not be a qualifying plan asset.
 - If plan provides for a brokerage window, self-directed brokerage account, assets held in such account are treated as qualifying plan assets if participant receives a statement of such assets at least annually.

QUESTIONS?